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Report to the Chairman, Subcommittee
on Investigations, Committee on Armed
Services, House of Representatives

April 1991

**DEFENSE
CONTRACT AUDITS**

**Current Organizational
Relationships and
Responsibilities**



143783

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Comptroller General
of the United States

B-241812

April 3, 1991

The Honorable Nicholas Mavroules
Chairman, Subcommittee on Investigations
Committee on Armed Services
House of Representatives

Dear Mr. Chairman:

This report responds to your December 13, 1989, letter requesting information on the Department of Defense's (DOD) organizational structure for performing contract audits. As agreed with your staff, we are responding to your request in two phases. The first phase, which is the subject of this report, addresses questions concerning organizational relationships and responsibilities for contract auditing within DOD. Specifically, this report provides information on (1) the delineation of contract auditing responsibilities within DOD, (2) the determination of the Defense Contract Audit Agency's (DCAA) contract auditing priorities and changes in DCAA's work load since the DOD Inspector General (IG) was established in 1982, and (3) whether alternative organizational structures would improve contract auditing in DOD. Phase two will focus on questions relating to DCAA's use of its staff resources.

Results in Brief

DOD has delineated the contract audit performance and oversight responsibilities of DCAA, the DOD IG, and the DOD Comptroller. DCAA is responsible for performing contract audits for all DOD components responsible for procurement and contract administration. The DOD Comptroller exercises management control over DCAA, and, to ensure that DCAA practices comply with laws, regulations, and auditing standards, the IG exercises oversight responsibility.

DOD organizations responsible for acquisitions influence DCAA's audit priorities by requesting that DCAA perform contract audits in accordance with Federal Acquisition Regulations. However, DCAA has great latitude in deciding what to do, when to do it, and how much needs to be done. Further, through a number of formal and informal means, DCAA's annual audit plans and priorities are coordinated with acquisition officials.

Since the DOD IG position was established in fiscal year 1982, DCAA's audit priorities have remained the same. Requests for forward pricing audits are the number one audit priority, followed by defective pricing audits, incurred cost audits, cost accounting standards audits, and other

audit-related activities. (See appendix I for a description of DCAA's major audit categories.) Although audit priorities have remained the same, changes have occurred in DCAA's audit workload. Forward pricing audits were the largest component of DCAA's workload in fiscal year 1982, but incurred cost audits are currently the largest component due to authorized increases in DCAA staff directed toward reducing a backlog of these audits. Overall, DCAA's workload has increased in most audit components since the IG was established.

During the past decade, numerous proposals have been made to reorganize DOD's structure for performing contract audits, including bills which would place DCAA in the Office of the Under Secretary of Defense (Acquisition) or in the Office of the Inspector General, or place only DCAA's postcontract audits in the Office of the Inspector General. We believe that audit independence and oversight could be impaired if DCAA were placed in either office, and that less coordinated or inefficient audit efforts could result from splitting contract auditing between two separate organizations. We believe, therefore, that DOD's current organizational structure for contract audits provides a more effective means for coordinated and independent audits.

Background

The Department of Defense procured approximately \$140 billion in goods and services during fiscal year 1989. This represents about half of its annual budget. Many of its acquisitions are for specialized equipment or services with no established market price. Accordingly, DOD must negotiate a contract price based primarily on estimates of the cost of labor, material, and overhead. To ensure that the government has the best available information during the negotiation, administration, and settlement of its procurement contracts, the DOD supplement to the Federal Acquisition Regulations requires DCAA to audit selected types of contracts at key points in the contracting process.

Before DCAA was established, contract audit responsibilities were divided among the various military components. In 1965, the Secretary of Defense merged these various contract audit components to form DCAA. DCAA currently provides the majority of contract audit services as well as related financial information and advice to DOD components engaged in procurement activities.¹ In addition, DCAA audits contracts for other government agencies, such as the Department of Energy and the

¹The Corps of Engineers performs a small amount of contract audit services for those contracts which receive civil funding.

National Aeronautics and Space Administration. These functions are performed at contractor facilities generally located where DOD has a continuing audit interest or where it is more economical than having these agencies establish their own contract audit operations. DCAA is reimbursed for audit services provided to other government agencies.

DCAA performs audits in four general categories—forward pricing, incurred cost, defective pricing, and cost accounting standards. It also performs other audit-related activities. (See appendix I.) It carries out its mission through a headquarters unit located in Alexandria, Virginia, and six regional offices located in Marietta, Georgia; Waltham, Massachusetts; La Mirada, California; Philadelphia; Irving, Texas; and San Francisco. These regional offices are responsible for DCAA's audit operations through 455 field locations at or near defense contractors' plants. For fiscal year 1990, DCAA was authorized 6,735 staff and received \$323 million in appropriated funds.

Objectives, Scope, and Methodology

As agreed with your staff, the objectives of this report were to determine

- if there are clear delineations of contract audit responsibilities for DCAA, the DOD IG, and the DOD Comptroller;
- how DCAA's audit priorities and work load are decided and how they have changed since the DOD IG was established in 1982; and
- if more desirable alternatives exist to the present structure for providing contract audits.

To determine whether there is clear delineation of contract audit responsibilities for DCAA, the DOD IG, and the DOD Comptroller, we talked with officials from each component to obtain their views on the roles and responsibilities of each of their organizations. We also obtained documents from them describing their missions and responsibilities. In addition, we reviewed summaries of all DOD IG audit reports issued during fiscal years 1987, 1988, and 1989 to identify areas where audit work performed by the IG was similar to that performed by DCAA. After reviewing the summaries, we interviewed audit staff who worked on the similar audits to obtain their views on how the organizations coordinated their work. We also reviewed coordination documents between the audit organizations involved.

To determine how DCAA decides audit priorities and work load, we obtained DCAA's planning and budgeting documents for fiscal years 1982

through 1990. We reviewed the documents and talked with officials from DCAA and the office of the Under Secretary of Defense (Acquisition) to identify DOD acquisition organizations' roles in the process used to develop the documents.

To identify changes in DCAA's audit priorities and work load since the DOD IG was established, we reviewed records pertaining to the utilization of DCAA's audit resources for fiscal years 1982 through 1989.

To determine whether more desirable alternatives exist to the present structure for providing contract audits, we analyzed several alternatives contained in proposed legislation. We discussed the alternatives with DOD officials responsible for DOD procurement and contract audit activities and with representatives from two defense contractor associations—the National Security Industrial Association and the Professional Services Council. Appendix II lists the firms represented during discussions with the associations.

We performed our review from December 1989 through September 1990 in accordance with generally accepted government auditing standards. We discussed our findings with responsible officials of the DOD Inspector General, the DOD Comptroller, the Under Secretary of Defense (Acquisition), and the Defense Contract Audit Agency. Their comments are incorporated where appropriate.

Contract Audit Responsibilities Are Delineated Within DOD

DOD has delineated the contract audit oversight and performance responsibilities of DCAA, the DOD IG, and the DOD Comptroller. DCAA is responsible for performing contract audits for DOD organizations as well as certain other government organizations responsible for procurement and contract administration. The Comptroller exercises management control over DCAA, and the IG exercises oversight responsibility over DCAA to ensure that DCAA practices comply with regulations and auditing standards.

DCAA is headed by a director who reports to the DOD Comptroller. The Director is responsible for day-to-day management of DCAA, development of strategic plans, audit guidance and procedures, and the quality of DCAA's audit services. The role of the agency is that of an independent advisor to DOD contracting officers in connection with the audits it conducts, which are an integral part of the negotiation, administration, and settlement of government contracts. In this way, DCAA is also intended to

serve the Secretary of Defense as an internal control for achieving prudent contracting within DOD.

The DOD Comptroller exercises management control over DCAA and is responsible for resolving any policy issues which may keep DCAA from effectively carrying out its primary responsibilities for supporting DOD's contracting officers. The current organizational placement of DCAA ensures access by the Comptroller to financial information on defense contracts and allows the Comptroller to make this information readily available to the Secretary and Deputy Secretary of Defense. In addition, it permits the Comptroller to elevate policy issues concerning the scope of DCAA's authority and level of resources.

The Inspector General Act of 1978, as amended, gives the DOD IG broad responsibilities to conduct and oversee audits and investigations in DOD and in contractor operations, if warranted. The IG's duties and responsibilities which are relevant to DCAA include (1) providing policy direction for all DOD audits relating to fraud, waste, and abuse, (2) investigating fraud, waste, and abuse uncovered as a result of audits, (3) monitoring and evaluating adherence by all DOD auditors to audit policies, procedures, and standards, and (4) requesting assistance as needed from other auditors in DOD.

Since 1982, the IG has issued over 52 audit reports regarding the efficiency, effectiveness, and quality of DCAA's audits. These reports resulted from the IG's audit oversight responsibilities and have recommended improvements throughout DCAA.

Because its duties and responsibilities are broad, the IG may become involved in matters that are also the responsibility of the Comptroller or the DCAA Director. However, we found that the DOD IG's involvement is well coordinated. For example, following revelations of overpricing in the procurement of DOD spare parts, the DOD IG initiated, at the request of the Secretary of Defense, a series of defective pricing audits for spare parts. The DOD IG requested DCAA's assistance with the audits, which are normally conducted by DCAA. We talked with officials in both DCAA and the IG's office and found that they had coordinated their audit efforts in order to prevent duplication and to effectively use DCAA audit staff who were on-site at the contractors under audit. IG auditors performed the audits at other locations lacking on-site DCAA staff.

DCAA's Audit Priorities Have Remained the Same but the Work Load Has Increased in Most Areas

DCAA's audit priorities and work load are directly influenced by Federal Acquisition Regulations and indirectly by DOD organizations responsible for acquisitions. While audit priorities have remained the same since the DOD IG was established in 1982, DCAA's work load has increased in each audit component during the period, with incurred cost audit work load increasing more than others because of the larger backlog in this area. (See figure 1.) In addition, DCAA's audit support for IG investigations increased while its reimbursable audit work declined. DCAA's overall staffing levels also nearly doubled from approximately 3,400 to over 6,700 during the period.

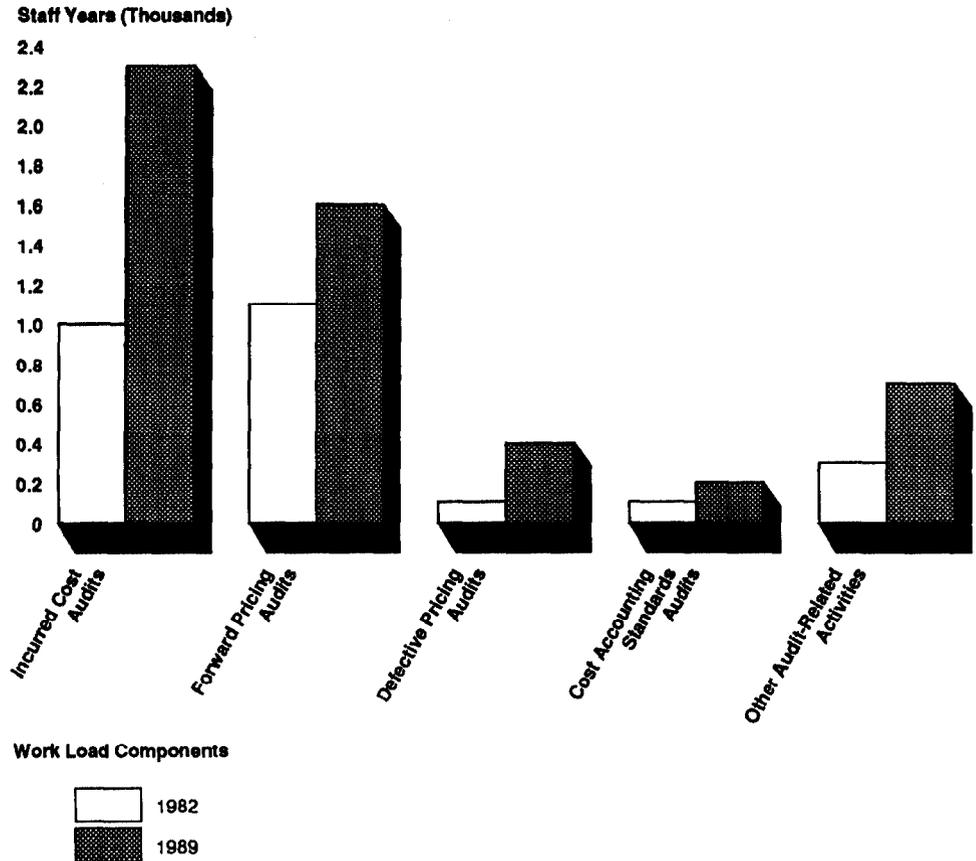
Federal Acquisition Regulations require contracting officers to obtain audits for certain procurement actions. The Under Secretary of Defense (Acquisition) is responsible for supervising the performance of the entire DOD acquisition process but has no direct oversight responsibility over DCAA. However, acquisition officials do provide input into the development of DCAA's annual audit plans and priorities.

DCAA policies require auditors to respond to contracting officers' requests for forward pricing audits before addressing other audit components. Forward pricing audits, which are mainly evaluations of price proposals, are the most time-sensitive requests and normally require less time than other audits. Defective pricing audits are second in priority, followed by incurred cost audits, cost accounting standards audits, and other audit-related activities.

Until recently, forward pricing audits were the largest component of DCAA's work load, followed by incurred cost audits. However, incurred cost audits are now the largest component. This shift was not caused by a change in audit priorities but rather by a significant increase in DCAA staff directed toward reducing a backlog of incurred cost audits, which had grown to 13,929 as of January 31, 1990.²

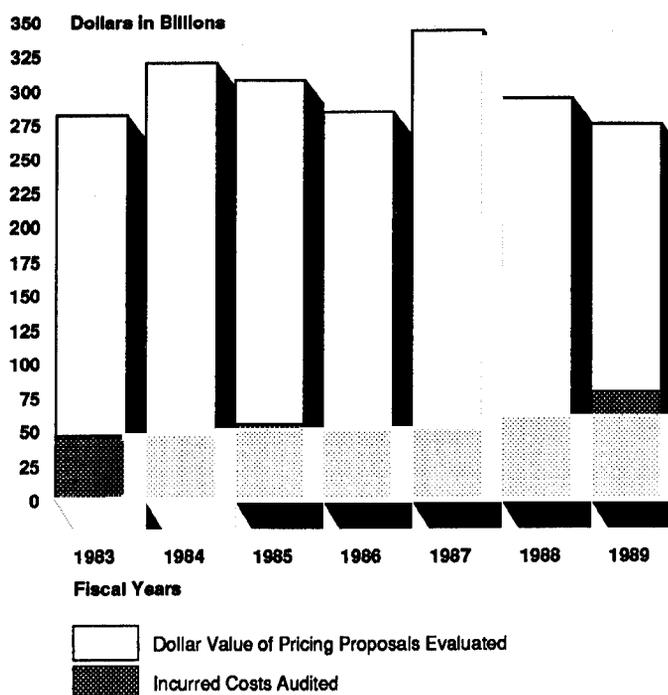
²As of December 31, 1989, the backlog of incurred cost audits involved \$169 billion.

Figure 1: Comparison of DCAA's Work Load Distribution for Fiscal Years 1982 and 1989



DCAA was able to direct more resources toward clearing the backlog of incurred cost audits because the Congress authorized additional staff for this purpose in fiscal years 1987 and 1989. In addition, the general decline in defense procurement since fiscal year 1987 necessitated fewer price proposal evaluations, which allowed more staff resources for incurred cost audits. As a result, the dollar value of evaluated price proposals declined by approximately 35 percent, while the amount of incurred costs audited increased by almost 52 percent during the same years. (See figure 2.) For fiscal year 1989, DCAA reported combined government savings of \$7.3 billion from both types of audits.

Figure 2: Summary of Contract Dollars Audited by DCAA for Fiscal Years 1983 Through 1989



DCAA has also increased its support of IG investigations of alleged procurement fraud from 21 staff years in fiscal year 1983 to 90 staff years in fiscal year 1989. DCAA reimbursable audit work for nondefense agencies decreased from 559 staff years in fiscal year 1982 to 403 staff years in fiscal year 1989. A DCAA official attributed the decline to (1) an increase in defense spending coupled with a decline in nondefense program spending and (2) reduced requests for audit services by the Department of Energy.

Proposals to Change DOD's Organizational Structure for Contract Auditing

We analyzed three proposed alternatives to the current organizational structure for performing contract audits in DOD. The first alternative would place DCAA under the supervision of the Under Secretary of Defense (Acquisition) or have the Under Secretary provide contract audit policy for DCAA. The second would place DCAA under the supervision of the DOD IG; and the third would transfer DCAA's postcontract audit responsibilities (incurred cost and defective pricing audits) to the DOD IG.

In the following sections, we present a separate discussion of each of the three proposed alternatives. These discussions include our views and

the views of DOD officials whose organizations would be directly affected by each alternative. We also present the views of industry representatives regarding their preferred alternatives.

Placing DCAA Under the Under Secretary of Defense (Acquisition)

A bill (S. 2151, 99th Cong.) before the Subcommittee on Defense Acquisition Policy of the Senate Committee on Armed Services in 1986 proposed placing DCAA under the authority of the Under Secretary of Defense (Acquisition) in order to centralize the supervision of DOD acquisition policy. In addition, the President's Blue Ribbon Commission on Defense Management (Packard Commission), recommended in its June 1986 report that the Under Secretary of Defense (Acquisition) oversee the establishment of DOD-wide contract audit policy and supervise establishment of DOD-wide policy for oversight of defense contractors in order to better coordinate DOD's oversight agencies.

We recognize that some aspects of DCAA's work, particularly the precontract work, could be deemed a procurement advisory function as well as an audit function and thus benefit from closer ties to acquisition officials. While we support close ties between the contracting officers and the auditors during the pricing and negotiation of the contracts, we believe that DCAA, as an audit organization, should report to an activity independent of the organization responsible for defense acquisitions. In previous testimony,³ we stated that the organizational arrangements contemplated by S. 2151, which would have DCAA auditors working for and reporting to the activity responsible for acquisition, would violate the basic auditing standard of independence. If under the supervision of an acquisition official, any pressures on those involved in the audit, whether real or perceived, can reduce the integrity and objectivity of the audit results. Moreover, in a subsequent report,⁴ we stated that we do not support the designation of the Under Secretary of Defense (Acquisition) to establish and oversee contract audit policy because officials or organizations charged with operational responsibility should not control or determine audit and investigative policy.

DOD officials we interviewed do not favor the proposal to place DCAA under the authority of the Under Secretary of Defense (Acquisition). The DOD Comptroller, the DOD IG, and the Director of DCAA all believe this

³Statement of Paul F. Math, GAO, before the U.S. Senate, Committee of Armed Services, Subcommittee on Defense Acquisition Policy (March 27, 1986).

⁴Defense Management: Status of Recommendations by Blue Ribbon Commission on Defense Management (GAO/NSLAD-89-19FS, November 4, 1988).

alternative would violate the government independence auditing standards which state that officials or organizations charged with operational responsibilities should not control or determine audit policy. Further, the Director of DCAA believes DCAA's organizational placement should be such that there is no actual or perceived impairment to independence. An official of the office of the Under Secretary of Defense (Acquisition) stated that DCAA could function effectively under Acquisition without impairing its independence but does not favor a change at this time because DCAA is responsive to the needs of contracting officials under the current arrangement.

In contrast, industry representatives told us that they prefer placing DCAA under the authority of the Under Secretary of Defense (Acquisitions). According to the representatives, adopting this change would improve the working relationship between contractors and the DOD organizations responsible for acquisitions by lessening the influence they believe the DOD IG currently exerts over DCAA. For example, industry representatives we spoke to believe that DOD policies requiring contracting officers to provide written justifications when deviating from recommendations made in DCAA audit reports have resulted in DCAA auditors having more influence over the contract negotiations process than contracting officers do. Industry representatives attribute this influence to the IG's role in overseeing the contract auditing process.

Under current DOD policy, contracting officers are the final decision makers in contractual matters, and disagreements with contract audit recommendations are to be addressed through the normal management review process. During our review, we found no examples of undue influence on DCAA by the DOD IG in providing audit policy guidance and oversight for improving contract auditing and DCAA operations. We believe, therefore, that the present organizational relationships provide DOD with an effective oversight process without impairing the activities of its contracting officers.

Placing DCAA Under the DOD IG

Placement of DCAA under the direction and control of the DOD IG was proposed most recently by H.R. 2361 (101st Cong.) and by the proposed Defense Contract Audit Agency Abolition Act of 1984 (S. 2381, 98th Cong.). Both proposals sought to modify and improve audit functions within DOD.

DCAA performs a variety of functions. In addition to audits, DCAA provides contract advisory services in connection with the negotiation,

administration, and settlement of contracts. The DOD IG currently has oversight of this function. As we have previously stated,⁵ transferring contract advisory services to the DOD IG would raise questions about the perception of the IG's independence and objectivity when auditing these services.

The DOD IG is not advocating this alternative, and other DOD officials oppose it. Some concerns raised by DOD officials opposing this arrangement are that

- DCAA's mission would become more investigative and less advisory and
- problems would exist during contract negotiations because contracting officers might feel pressured to implement all of the IG's recommendations, thereby disrupting the normal business negotiations process.

Proposal to Transfer Postcontract Audits to the DOD IG

A proposal to transfer responsibility for the postcontract audit portion of DCAA's work to the DOD IG was considered during congressional legislation establishing the DOD IG in 1982. Instead of passing that provision, the Congress authorized the DOD IG 100 additional staff members with contract audit experience to oversee both DCAA contract audit work and the entire procurement process—the performance of defense contractors as well as DOD personnel.

We believe that unlike precontract audits, which have aspects of a procurement support function, DCAA's postcontract audit work may be more consistent with the types of audit work performed by the DOD IG. We also believe, however, that if the contract audit function related to precontract and postcontract audits were split between two organizations, the same books and records of the defense contractors would be reviewed by two different government organizations. We believe that contract auditing can be more coordinated and efficient when performed by a single organization than if split between two separate organizations.

DOD officials do not favor transferring DCAA's postcontract audit work to the DOD IG. Some told us that this alternative could cause duplication of audit efforts at contractor plant facilities and produce inconsistent audit determinations by the separate audit organizations.

⁵See letters dated April 4, 1984, to the Chairman, Committee on Government Operations, House of Representatives, B-214045; and April 30, 1984, to the Chairman, Committee on Governmental Affairs, U.S. Senate, B-214045.

Conclusions

Contract audit functions within the Department of Defense are clearly delineated. Even though the DOD IG, the Comptroller, and the Under Secretary of Defense (Acquisition) all have responsibilities and common concerns for certain aspects of DCAA's operations, they have established a coordinated working relationship. The DOD IG and the Comptroller each has some responsibilities for DCAA's operation, and the Under Secretary of Defense (Acquisition) supervises the entire acquisition process.

DCAA's audit priorities and work load are directly influenced by Federal Acquisition Regulations and indirectly by DOD organizations responsible for acquisitions. While audit priorities have remained the same, DCAA's work load has increased in most audit components since the IG was established. Moreover, these increases seem to reflect specific staff increases recently authorized by the Congress to address the backlog of incurred cost audits.

The current organizational structure for contract audits provides contract audit independence and effective audit oversight, and allows DCAA to respond to acquisitions officials. The proposed alternatives raise questions regarding audit independence and oversight, and present the possibility of uncoordinated audit efforts. Due to these concerns, we believe that DOD's current organizational structure for contract audits provides a more effective means for independent and coordinated audits.

As agreed with your office, unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days from its date. At that time, we will send copies of the report to the Director of the Office of Management and Budget, the Secretary of Defense, and interested congressional committees. We will also make copies available upon request.

This report was prepared under the direction of David L. Clark, Director, Legislative Reviews and Audit Oversight, who may be reached on (202) 275-9507 if you or your staff have any questions. Other contributors are listed in appendix III.

Sincerely yours,



Charles A. Bowsher
Comptroller General
of the United States

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Abbreviations

DCAA	Defense Contract Audit Agency
DOD	Department of Defense
IG	Inspector General

Description of DCAA's Major Audit Categories

DCAA's audit work load is divided into five major functional components or mission areas which account for DCAA's use of direct audit resources. The functional components are (1) forward pricing audits, (2) audits of incurred costs, (3) defective pricing audits, (4) cost accounting standards audits, and (5) other audit-related activities.

Forward pricing audits: The Federal Acquisition Regulations provide for forward pricing audits which involve a review of (1) estimated future costs included in proposed contracts, (2) proposed contract change orders, and (3) costs incurred but not yet covered by formal contracts. The proposed costs subject to audit are direct labor, direct materials, subcontracts, other direct costs, and indirect costs, such as overhead and general administrative costs.

The ultimate goal of a forward pricing audit is to provide contracting officers with a detailed analysis of prospective contract costs. This analysis should assist them in determining and negotiating fair and reasonable prices for a negotiated government contract. Such an audit must be accomplished within a short period in order to complete the award of a contract.

Incurred cost audits: Federal Acquisition Regulations require DCAA to audit costs incurred on cost reimbursable, fixed-price incentive, and other types of flexibly-priced contracts. Incurred cost audits also include an appraisal of contractors' operations and procedures which affect the costs charged to government contracts. In general, these audits determine the allocability of costs that contractors report they incur in flexibly-priced contracts. Usually, the government pays a large portion of the incurred costs before an audit and retains reserves for potential audit disallowances.

Incurred cost audits are designed to ensure that labor, material, and overhead costs incurred under or charged to specific government contracts are allowable, allocable, and reasonable under terms of the contract, the Federal Acquisition Regulations, and applicable cost accounting standards. For example, by examining contractors' accounting, operational, and internal control systems, the auditor can determine whether the systems can generate accurate and reliable contract cost information.

Although the primary purpose of incurred cost audits is to express an opinion on the acceptability of costs claimed under government contracts, knowledge of contractors' accounting, estimating, and internal

Appendix I
Description of DCAA's Major
Audit Categories

control systems gained during these audits helps the auditor to evaluate contractors' prospective price proposals in forward pricing efforts.

Defective pricing audits: Under provisions of the Truth in Negotiations Act, 10 U.S.C. 2306a, DCAA performs defective pricing reviews to determine whether a contract or subcontract price was unduly increased because the contractor or subcontractor failed to furnish accurate, complete, or current cost or pricing information in negotiating the contract.

Cost Accounting Standards Audits: Most contractors are required to follow these standards as a condition of government contracting under Public Law 100-679 and Federal Acquisition Regulations. DCAA reviews contractors' implementation of and compliance with cost accounting standards.

Other audit-related activities: DCAA also carries out other audit-related activities. The major audit-related activities that DCAA performs are procurement liaison activities, contract audit coordination programs, negotiation conferences, external audit interface, special projects, planning, audit follow-up, and review of postnegotiation memorandums.

Defense Industry Firms/ Associations Represented

**National Security
Industrial Association**

Automated Sciences Group, Inc.
Loral-LIRIS
IBM Systems Integration Division
Electronic Data Systems
IBM Corporation, Federal Systems Division
The Boeing Company
Westinghouse Electric Corporation
Seyfarth, Shaw, Fairweather & Geraldson
GTE, Government Systems Corporation
Deloitte & Touche

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